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REVEALING THE VALUE OF SUSTAINABLE DEVELOPMENT

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Profitability is necessary but not sufficient to generate sustainable shareholder value. The real purpose of profitability is continuity – enabling a company to survive, adapt, innovate, and grow. Today, financial analysts and investors are beginning to evaluate companies not just based on projected financial performance, but also based on intangible value drivers such as intellectual capital, customer relationships, and reputation. Yet the related concept of sustainable development (SD) is still unfamiliar to the mainstream financial community.

"The Discipline of Sustainable Value" in this issue of Corporate Strategy Today, describes a "win-win" framework whereby companies can create sustainable value for both their stakeholders and shareholders. Below, we show further that the environmental, social, and economic interests of stakeholders are closely linked to the intangible drivers of shareholder value, and describe new tools for identifying these linkages. We will use the experiences of well-known companies who are early adopters of SD to illustrate how insights into value creation result in new sources of competitive advantage.

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Certain companies are able to create sustainable value over the long run because of intangible strengths such as vision, creativity, and dedication, which do not appear on financial statements. In the words of Collins and Porras[1], they are "built to last." Future financial performance is a consequence of excellence in leveraging these underlying strengths – thus, many investment analysts view these intangibles as leading indicators of market value. It is important to note, as shown in Figure 1, that the quality of intangibles is driven primarily by excellence in staff functions – in a sense, intangibles are the "products" of staff performance.

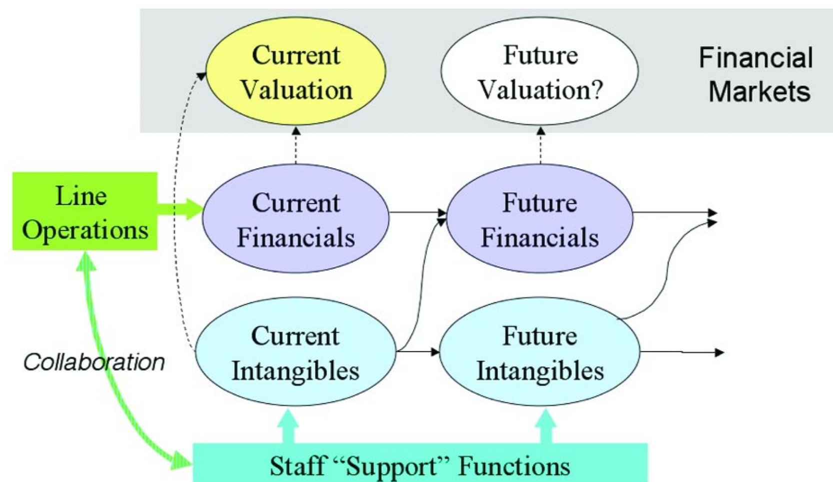

Figure 1: Intangibles are leading indicators of future market value, and are driven primarily by staff performance, while financial performance is driven primarily by line operations

What are these intangibles? They are no mystery, although different analysts may describe them using different groupings and terminology. The "Balanced Scorecard" framework, popularized by Kaplan and Norton[2] , proposes

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measurement of three major non-financial perspectives that drive financial performance:

- The Learning and Growth perspective stresses internal training and cultural norms that continually refresh the enterprise's knowledge assets

- The Business Process perspective stresses operational excellence in carrying out the key processes that make the enterprise run

- The Customer perspective stresses understanding and satisfaction of changing customer needs and expectations

The Balanced Scorecard framework is extremely robust and flexible, but leaves it up to the practitioner to select the indicators that need to be measured within each of these broad perspectives. It does not explicitly identify key intangibles such as innovation or stakeholder engagement that may be extremely important in certain industries.

Another approach toward understanding non-financial value drivers is to view them as enterprise assets. The "intellectual capital" model developed by Stewart[3] and others includes the following categories of intangible assets:

- Human Capital – skills and knowledge of management and employees
- Structural Capital – patents and proprietary data, methodologies or processes
- Relationship Capital – bonds with customers and suppliers, and brand identity

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Leading companies such as DuPont and General Electric have systematically worked to substitute intellectual capital for physical capital as a means of increasing shareholder value. Intellectual capital is less expensive to maintain and easier to leverage, especially in an age of instant electronic communication. Many industry analysts believe that knowledge assets rather than physical assets will become the basis of future competition.

UNDERSTANDING AND MANAGING INTANGIBLE ASSETS

Recent research by Cap Gemini Ernst & Young[4] (CGEY) provides a more fine-grain enumeration of the intangible assets considered most important by senior executives and investment analysts. Using intangible performance indicators, they have been able to demonstrate statistical correlations between strength of intangibles and market value. They have also found that about 35% of portfolio investment decisions are driven by intangibles. CGEY ranks the following value drivers as most important:

1. **Innovation**: Ability to innovate; effectiveness of new product development; knowledge creation and use.
2. **Quality**: Reliability, flexibility; logistics & quality systems.
3. **Customer**: Customer relationships, intimacy and loyalty.
4. **Leadership**: Management capabilities, experience and future vision; transparency, trust, accountability.
5. **Alliances**: Supply chain; strategic networks; partnerships.
6. **Technology**: Process know-how; information technology.
7. **Brand Equity**: Strength of market position and brand image.
8. **Employee**: Talent acquisition, retention, compensation.
9. **Environment**: Compliance, risk management, reputation.

It is possible to roughly map the Balanced Scorecard and Intellectual Capital

frameworks into these drivers. For example, Learning and Growth corresponds to a combination of Innovation, Human Capital, and Leadership. Likewise, Relationship Capital corresponds to a combination of Customer, Alliances, and Brand Equity. However, there is no obvious Balanced Scorecard mapping for certain key drivers such as Technology, Brand Equity, or Environment. Moreover, neither the CGEY framework nor the Intellectual Capital framework explicitly identify two important types of intangible assets that are external to the enterprise but can provide value nonetheless:

- Natural Capital[5] refers to the natural resources and ecosystem services that make possible all economic activity, indeed all life.
- Social Capital[6] refers to the institutions, relationships, and norms that shape social interactions and societal cohesion.

Every conceptual approach has its own merits, and the particular approach adopted by a company is not so important – what matters is comprehensiveness and effective execution. The advantage of embracing one approach is that it can be communicated effectively and can generate passion and enthusiasm within the workforce. However, there is an important caveat: Passionate adherence to a particular perspective may neglect key enterprise assets that fall outside that perspective.

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Thus, a focus on Quality and implementation of Six Sigma programs may improve critical business processes but may neglect Human Capital. Similarly, an emphasis on Customer may enhance customer loyalty but may neglect Technology. Zealous advocates of a particular perspective often view it as overarching, and tend to subsume other ideas as derivative concepts. This can be problematic if it leads to inappropriate applications of the tools – when you possess a hammer, everything looks like a nail. Many companies have tried to apply methods such as quality improvement or re-engineering to all their business processes, with decidedly mixed results.

Developing a Business Case for Sustainable Development

Sustainable Development (SD) is an emerging strategic issue in both U.S. and global markets. The United Nations defined the principle of SD as follows: Development today must not undermine the development and environment needs of present and future generations[7]. In other words, as we strive for prosperity today, we must not compromise quality of life for our descendants. A more useful definition for business purposes is as follows: A sustainable enterprise is a company that delivers enduring growth and superior long-term financial returns by addressing the economic, social and environmental needs of all stakeholders, including employees, customers, shareholders communities, regulators, and other interested parties. These three major dimensions of SD – economic, social, and environmental – are often called the "triple bottom line."

Many CEOs have asserted a belief that SD will improve both enterprise resource productivity and stakeholder confidence. According to KPMG, 36% of the top 100 U.S. companies now publish annual Sustainability Reports[8]. At the same time, a recent PriceWaterhouseCoopers survey of 140 U.S. companies, 101 of which are in the Fortune 1000, showed that 75% claim to have adopted sustainable business practices[9]. The most common reasons cited were enhanced reputation, competitive advantage, and cost savings. There are several factors that underlie this growing business interest in SD:

- SD not only provides direct financial benefits through greater efficiency,

but also enhances several intangible factors that are known to influence shareholder value including– reputation, brand equity, strategic relationships, human capital, and innovation.

- Top executives in the post-Enron era are increasingly stressing ethical obligations and accountability, including social responsibility, transparency, and constructive engagement with external stakeholders.
- Competitive pressures are mounting as more leading companies in every industry adopt progressive codes of conduct (e.g., CERES principles), openly report on their SD progress, and demand that their suppliers adhere to the same practices.
- Emerging regulatory initiatives embrace principles such as climate stabilization and extended producer responsibility, which broaden the boundaries of corporate accountability and raise public expectations regarding company practices.
- The financial community has begun to recognize that attention to sustainable development is an indicator of overall superior management, as exemplified by the increasing interest in the Dow Jones Sustainability Group Index.

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While corporate interest in SD has grown dramatically, few companies have been able to articulate a specific "business case" for adoption of SD. In reality, a serious corporate commitment to SD is invariably driven by a CEO mandate, backed up by generic policy statements and intuitive beliefs that SD makes business sense. One of the world's foremost proponents of SD is Chad Holliday, CEO of DuPont, who recently served as chair of the World Business Council for Sustainable Development (WBCSD). DuPont no longer views sustainability as a separate thrust, but instead has woven SD thinking into its three corporate strategic priorities:

- Knowledge intensity – creating products and services that deliver greater value to customers and shareholders with less physical mass (DuPont actually created a metric to quantify knowledge intensity – shareholder value per lb.).
- Productivity – improving operating efficiency and capital utilization while reducing the supply chain environmental footprint.
- Integrated science - seeking technological innovations that improve quality of life, e.g., by enhancing safety, recyclability, or nutrition.

Holliday has co-authored a book containing dozens of examples of companies that have benefited by embracing SD principles[10]. Yet despite these success stories, the development of a business case for SD remains somewhat of a black art. Specific SD-related initiatives typically have been driven not by shareholder value considerations, but by reaction to external forces such as regulatory requirements and stakeholder pressures. For example, the European Union directives for end-of-life product take-back have prompted the electronics and automotive industries to rethink their product design and materials selection processes. This pattern is not surprising, since the main benefits of SD fall into the category of intangibles, which have rarely been quantified.

LINKING SUSTAINABLE DEVELOPMENT TO SHAREHOLDER VALUE

In order to incorporate SD more directly into business decision-making, it is important for companies to understand the direct and indirect contributions of SD to shareholder value, including the full spectrum of intangible assets. We have identified three major pathways toward value creation.

1. Direct, tangible: SD initiatives can contribute directly to tangible financial value by enabling growth, reducing costs, conserving capital, and decreasing risks. Examples of initiatives in each of these categories are given in Figure 2, showing how they influence the financial metric known as shareholder value added. For example, DuPont plans to expand into new markets by addressing unmet social needs[11]. Baxter Healthcare systematically measures and reports the contribution of its environmental programs to reductions in capital and operating costs[12].

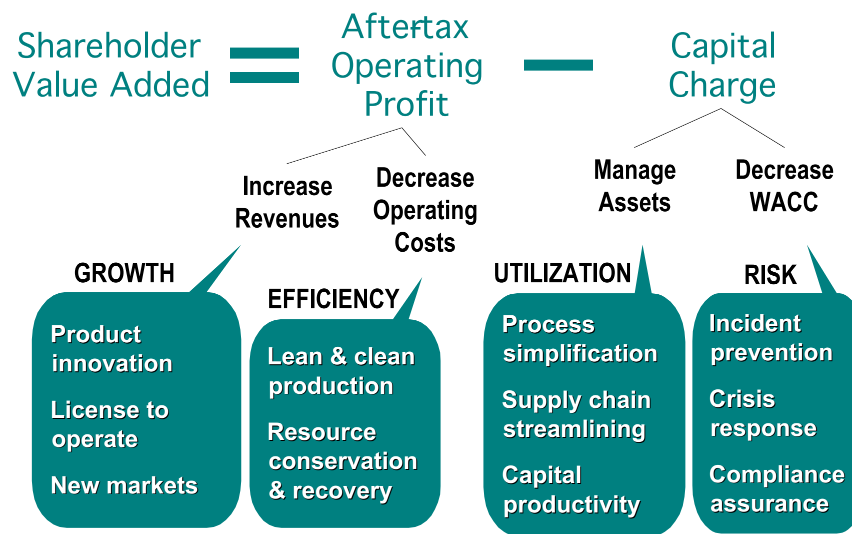


Figure 2: Sustainable development initiatives can contribute to enhancing both cash flow and capital utilization, frequently measured in terms of "shareholder value added."

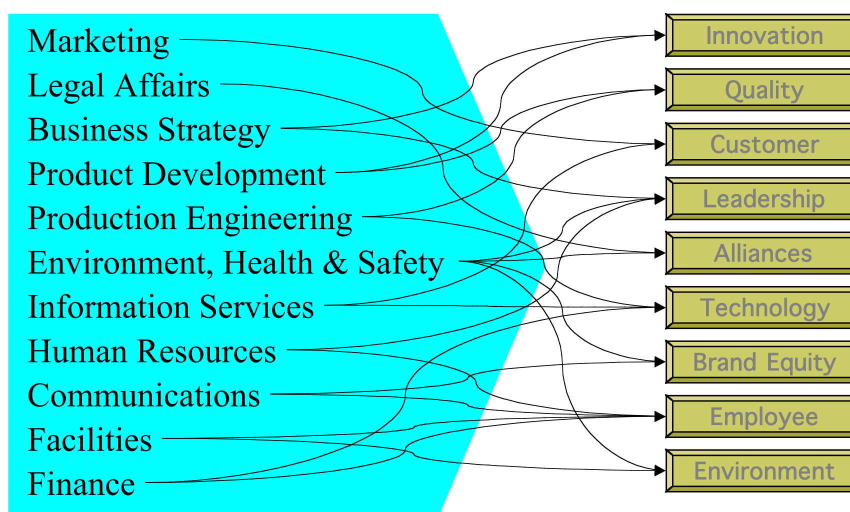
Lafarge, the global cement producer, has partnered with environmental groups, governments, and local communities in advancing ecological stewardship, thus helping to improve its public image and assure its continued license to operate.

2. Direct, intangible: SD initiatives can directly improve intangible assets. For example, an awareness of product life cycle issues can lead to Innovation in material selection and end-of-life recovery, as demonstrated by Eastman Kodak's pioneering efforts in design of the single-use FunSaver™ camera[13]. As part of its product stewardship commitment, Ashland Chemical has formed Alliances with Customers to promote safe, economical, and productive use of chemical products[14]. Ford Motor Company is building a sustainable automotive plant to demonstrate its Leadership and to improve Employee well-being[15]. Figure 3 illustrates that each intangible asset can be enhanced by collaboration among a number of staff groups, with EHS playing a prominent role.

3. Indirect, intangible: Finally, SD initiatives can indirectly enhance intangibles by creating value for external stakeholders. This ultimately benefits shareholders, because strengthening of relationships with customers and other key stakeholders is an important non-financial value driver. Each company can choose the stakeholder issues that are best aligned with its own interests and core competencies. For example, Procter & Gamble has focused its SD efforts on creating innovative products that address worldwide needs for water, health and hygiene[16]. Lafarge, the global cement producer, has partnered with environmental groups, governments, and local communities in advancing ecological stewardship, thus helping to improve its public image and assure its continued license to operate[17]. In general, important external stakeholder

groups can include customers, suppliers, local communities, regulators, lenders, suppliers, business partners, advocacy groups, religious groups and indigenous peoples. The principal intangible assets that can benefit from stakeholder engagement include Customer, Alliances, Brand Equity, and Employee.

Figure 3: Sustainable development initiatives can contribute to strengthening important intangible assets of the enterprise, requiring collaboration among several staff functions.



Using a value matrix, illustrated in Figure 4, the SBDF identifies linkages between SD outcomes and the company's ability to reduce costs, increase profits, and build competitive advantage.

The above three pathways to value creation were incorporated into a new tool called the Sustainable Business Decision Framework (SBDF), developed under the auspices of the World Business Council for Sustainable Development, and validated through several applications with multi-national cement companies[18]. The SBDF was motivated by a survey of global best practices across all industries, which revealed a widespread need for decision methods to account for SD-related trade-offs and thus support business case

Figure 4: Simplified illustration of the Sustainable Business Decision Framework. Creating value for external stakeholders provides intangible strategic benefits to the enterprise, while improving environmental and social performance provides tangible financial benefits to the enterprise.

Financial Benefits: Improved asset utilization
Operating cost reduction
Liability avoidance
Revenue growth

		Economic	Environmental	Social
Enterprise Value	Shareholders & investors	**Financial results** (EBITDA, etc.)	Risk management	Social responsibility
	Managers	Business results & Personal income	Resource efficiency & waste reduction	Safety & Productivity
	Employees	Personal income	Workplace conditions	Pride
External Stakeholder Value	Neighboring residents	Property values	Airborne emissions, noise, aesthetics	Employment opportunities
	Labor Unions	Wages & benefits	Occupational Health	Worker rights
	Advocacy groups	Poverty alleviation	Ecosystem protection & restoration	Social equity
	Government agencies	Tax revenue base	Regulatory compliance & cooperation	Human rights & justice
	Regional Interests	Economic growth & prosperity	Environmental quality	Education & health care
	Customers	Product price	Recycling practices	Reputation

Strategic Benefits:
Right to operate
Relationships
Public image

development. Using a value matrix, illustrated in Figure 4, the SBDF identifies linkages between SD outcomes and the company's ability to reduce costs, increase profits, and build competitive advantage. Thus, it enables integration of SD into strategic and tactical decisions, including trade-offs between financial gains and longer-term concerns such as company image and future barriers to growth. It also helps to assure that voluntary SD initiatives will deliver maximum benefits in terms of shareholder value.

The SBDF can be used in several ways: (a) by senior management to establish broad objectives and decision guidelines that consider SD; (b) by decision-makers to include SD considerations in business case development; and (c) by external relations staff to support a balanced dialogue with stakeholders, including financial analysts.

IMPLEMENTING SUSTAINABILITY IN THE NEAR FUTURE

While many businesses and non-governmental organizations continue to actively promote sustainability concepts, it is instructive to take a more dispassionate view of SD from an enterprise management perspective. After approximately a decade of experience with SD implementation, lessons have emerged and some fallacies have become evident.

SD investment is growing. SD investors are divided into two distinct investment styles. Together, these groups have grown to comprise as much as 10 to 15% of all managed assets.

- The social and economic dimensions of SD are confusing. SD advocates have used the social dimension as a catchall bucket for a host of issues that do not logically fit together. For example, employee health, safety, and well-being (i.e., Human Capital) are quite distinct from other "social" issues such as equity, transparency, and community engagement. Likewise, the economic dimension confounds profitability and shareholder value creation with external contributions to economic welfare, including the emerging concept of "strategic corporate philanthropy" as a means of improving the competitive position of the firm[19].

- Sustainability reporting may have a limited time window. The development of sustainability reports has burgeoned, in many cases replacing EHS reporting. Yet it is still unclear whether a natural audience exists for these reports beyond the community of SD advocates. Some leading companies, such as Dofasco, the Canadian steel maker, have begun to incorporate their SD message directly into their annual report. This appears to be a logical shift if SD is to become an integral part of the corporate identity, and not just a clever "spin."

- SD investment is growing. SD investors are divided into two distinct investment styles[20]: (a) Socially responsible investing (e.g., FTSE4Good Index), in which ethical, environmental and social screening criteria are used to influence company behavior and thus enhance societal well-being; and (b) Sustainability investing (e.g., Dow Jones Sustainability Group Index, Innovest EcoVALUE '21), in which similar criteria are used to rate companies and identify attractive investments that deliver long-term shareholder value. Together, these groups have grown to comprise as much as 10 to 15% of all managed assets.

- The majority of investors are indifferent. Despite the above growth, SD remains a specialized field. Mainstream institutional investors and fund managers tend to consider environmental and social performance as second-order issues not worthy of attention. While acknowledging the importance of intangibles, they prefer to focus upon a familiar set of

fundamental attributes rather than delving into the arcane vocabulary of eco-efficiency and social responsibility.

- SD does not necessarily improve financial performance. Analysis of the Dow Jones Sustainability Group Index (DJSGI) over 3, 5 and 10-year periods shows that the DJSGI leaders, on the average, did not outperform the market. This should not be surprising – SD is not a magic formula for success. Nor does it invalidate the importance of SD for improving enterprise assets. The secret to success is not good intentions, but good strategy execution.

- The greatest value of SD is in building intangible assets. For all of the effort to quantify a business case for SD, financial performance remains the domain of line operations. With a few exceptions, the contributions of SD initiatives to revenue growth, cost reduction, or capital conservation are generally incremental, and therefore tactical in nature. On the other hand, the primary strategic value of SD initiatives such as environmental stewardship or community assistance lies in the enhancement of intangible assets such as Reputation and Human Capital, which exert a significant influence on shareholder perception and market value.

On the other hand, the primary strategic value of SD initiatives such as environmental stewardship or community assistance lies in the enhancement of intangible assets such as Reputation and Human Capital, which exert a significant influence on shareholder perception and market value.

- There is really only one bottom line. The triple bottom line metaphor was, no doubt, useful in expanding the consciousness of corporations regarding the needs and expectations of different stakeholder groups. However, the downside of this metaphor is that it encourages separate reporting of social and environmental indicators without a clear understanding of how they contribute to sustainable enterprise value. A more integrated view is needed of how social, economic, and environmental improvements collectively drive financial performance.

In summary, the SD community must adapt itself to the language and world-view of the finance and investment communities, rather than trying to "educate" them about the hidden value of SD. Although more CEOs may become SD champions, it is likely that the majority of line managers, chief financial officers, and external financial analysts will continue to adhere to traditional views. Unfortunately, this means that SD may continue to be associated with regulatory compliance and risk management, and that the many opportunities for gaining competitive advantage through SD may be lost.

Companies that grasp the important linkages between SD and shareholder value will be able to shift their SD initiatives from a stakeholder-driven approach to a value-driven approach, in which SD is one of many contributors to overall value. Ultimately, the real test of success for today's SD visionaries will be that "sustainability" as a separate concept fades away, and people across the enterprise learn to weave SD principles naturally into their strategic and tactical thinking. In the words of Charles Handy[21]:

> "The purpose of a business is not to make a profit, full stop. It is to make a profit so that the business can do something more or better. That 'something' becomes the real justification for the business."

ABOUT THE AUTHOR:

Dr. Joseph Fiksel, Principal and Co-Founder of Eco-Nomics LLC, is an internationally recognized authority on sustainable business practices. He has

over 20 years of management consulting experience, and recently directed a $2.5 million study of the global cement industry commissioned by the World Business Council for Sustainable Development. He has been engaged on several projects by the Global Environmental Management Initiative (GEMI), a consortium of 40 leading U.S. companies, to develop tools that capture the business value of environmental excellence and sustainability.

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